

New Jersey Pension Fund Shortfall Scrutinized

New Jersey's pension shortfall has received national attention, prompting Governor Jon Corzine to call for an independent audit of the \$79 billion state pension fund. The American Academy of Actuaries also plans to discuss the New Jersey situation at its next meeting.

On April 4, 2007, a lengthy [New York Times](#) article described how New Jersey allegedly diverted money that should have gone into the pension fund. The Times analysis alleged that the state recognized investment gains immediately but delayed the reporting of losses, used money earmarked for pensions for other purposes, and exaggerated how much money was contributed to the pension fund.

Donald Segal, Chairman of the American Academy of Actuaries' pension practice council, has placed state pension funding on its agenda after reading about the New Jersey funding issues. The council reportedly wants to discuss what can be done in the absence of federal pension rules. One possibility, according to Segal, is to change professional standards so that actuaries are required to speak out if a government is failing to make its required pension contributions.

The New Jersey situation was recently highlighted in the National Conference of State Legislatures' online magazine, [Governing.com](#), which referenced the [New York Times](#)' analysis.

You may access two New York Times articles on this topic by clicking on the attached PDF file.

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April 4, 2007

N.J. Pension Fund Endangered by Diverted Billions

By [MARY WILLIAMS WALSH](#)

In 2005, [New Jersey](#) put either \$551 million, \$56 million or nothing into its pension fund for teachers. All three figures appeared in various state documents — though the state now says that the actual amount was zero.

The phantom contribution is just one indication that New Jersey has been diverting billions of dollars from its pension fund for state and local workers into other government purposes over the last 15 years, using a variety of unorthodox transactions authorized by the Legislature and by governors from both political parties.

The state has long acknowledged that it has been putting less money into the pension fund than it should. But an analysis of its records by The New York Times shows that in many cases, New Jersey has overstated even what it has claimed to be contributing, sometimes by hundreds of millions of dollars.

The discrepancies raise questions about how much money is really in the New Jersey pension fund, which industry statistics show to be the ninth largest in the nation's public sector, with reported assets of \$79 billion.

State officials say the fund is in dire shape, with a serious deficit. It has enough to pay retirees for several years, but without big contributions, paid for by cuts elsewhere in the state's programs, higher taxes or another source, the fund could soon be caught in a downward spiral that could devastate the state's fiscal health. Under its Constitution, New Jersey cannot reduce earned pension benefits.

The Times's examination of New Jersey's pension fund showed that officials have taken questionable steps again and again. The state recorded investment gains immediately when the markets were up, for instance, then delayed recording losses when the markets were down. It reported money to pay for health care costs as contributions to the pension fund, though that money would soon flow out of the fund. It claimed it had "excess" assets that allowed it to divert required pension contributions to other uses, like providing financial assistance to poor school districts.

Frederick J. Beaver, director of the Division of Pensions and Benefits in the New Jersey Treasury Department, pointed out that other places had taken similar steps occasionally when dealing with a budget

crunch, but acknowledged that New Jersey was unusual. “The problem we had was doing it on a repeat basis,” he said.

An in-depth look at the reporting discrepancies for the teachers’ fund, which covers about 155,000 current teachers and 65,000 retirees, shows how the system ran awry over many years, using many questionable practices.

New Jersey recorded the \$551 million contribution for the 2005 fiscal year in a bond offering statement at the end of last year. The \$56 million figure appeared in an audited financial statement for the fund.

Treasury officials said that everything had been done legally. But they confirmed in a recent interview that the correct amount for that year’s pension contribution was zero, which appeared in an actuarial report. They explained that the conflicting figures elsewhere had been inflated by other items, like health care contributions.

If New Jersey violated federal securities, tax or other rules, it could be forced to make up some of the contributions. The [Internal Revenue Service](#) has very specific rules against mixing pension money with money for other uses, like health care. Federal securities law also requires bond issuers to provide complete and accurate financial information.

The New Jersey Education Association has sued the state for failing to put enough money into the teachers’ pension fund. The lawsuit does not describe all the accounting maneuvers, but a State Superior Court judge has held that the case, now scheduled for trial in May, can proceed.

State law requires New Jersey’s seven pension plans, large and small, for various types of public employees, to be funded according to actuarial standards. Over the last decade, though, the Legislature has passed, and various governors have signed, a series of amendments to statutes that allow smaller contributions or none. These were justified by various maneuvers and approved with little scrutiny. In interviews, officials of the Treasury said the changes were made at the behest of the Legislature, while legislators faulted the Treasury.

[Donald T. DiFrancesco](#), the acting governor in 2001, when the Legislature approved an expensive pension increase for teachers and other state employees, said he recalled that “people thought it was good public policy,” devised to attract the best people. He said he did not think the measure was considered financially unsound and did not recall anyone challenging it or calling it improper.

The state’s practices have nevertheless left its retirement system in a much more perilous condition than is widely understood.

“If people ran their households like this, they’d be in bankruptcy,” said Lynn E. Turner, a former chief

accountant for the Securities and Exchange Commission. “If businesses did, the best example is the old steel mills when they got so far behind and didn’t fund their pensions as they should have. It tipped them into bankruptcy.”

A Governor Seeks Changes

Since taking office in January 2006, Gov. [Jon S. Corzine](#), a former chairman of Goldman Sachs, has been warning that the pension fund is in worse shape than people may realize. “It’s impossible for us to stay on the course that we are on today, and deliver what people are asking for,” he said in an interview late last year. “The money will not be there.”

Governor Corzine has succeeded in getting the Legislature to contribute more to the pension fund, though not enough to meet its future obligations. There appears to be too little money to both restore the pension fund and fulfill the popular promise of property-tax relief without cutting services to an unacceptable level.

Governor Corzine has also pressed to raise the retirement age, increase employee contributions and to institute other changes to stem the growth of future costs. Now his administration is studying novel steps, like the sale of the New Jersey Turnpike.

Such strategies carry risks of their own. If the Corzine administration sells a big asset without first correcting the system’s entrenched problems, the new money could disappear into other government operations, too.

“When you sell the assets of the state, you’d better not use them for current spending. You’re eating your seed corn,” said Douglas A. Love, a member of the system’s investment oversight board. Mr. Love recently completed a calculation showing that the fund had not measured its future liabilities properly and estimated it had a \$56 billion deficit, much higher than the \$18 billion that the state had reported. Of course, the deficit could be greater if the assets have been inflated.

Increasing Federal Scrutiny

New Jersey’s situation may be extreme, but some other state and city governments will come under pressure in the coming years as longtime public workers retire in large numbers and the true cost of their benefit plans becomes more apparent.

The handling of public pension money has not drawn much scrutiny in the past but that is beginning to change. Members of the [United States Senate](#) have asked the [Government Accountability Office](#) for a review of public pension operations and whether new rules are needed.

The chairman of the Securities and Exchange Commission, Christopher Cox, recently said he wants to step up enforcement in the municipal bond markets and to improve financial reporting. He said he had come to

this conclusion after a scandal in San Diego, where officials put false information about the pension fund into bond offering statements. After an investigation, the S.E.C. found it amounted to securities fraud.

The Internal Revenue Service may also be flexing some muscles. It intervened in San Diego after learning that the city was using its pension fund to pay other expenses, like retiree health care costs. The money in pension funds gets preferred tax treatment and must be spent solely on pensions.

Andy Zuckerman, the I.R.S.'s director for employee plans, rulings and agreements, said he could not discuss New Jersey's situation because of rules on tax confidentiality. But in general, when local laws conflicted with the rules in the tax code, "the federal law applies, period."

When asked about the discrepancies in the records for New Jersey's pension plans, Treasury officials who met with two reporters at a conference room at an office building in Trenton last month acknowledged some unusual practices.

"We were not the ultimate decision-makers," said John D. Megariotis, the deputy director of the Division of Pensions and Benefits. "We were the bean-counters."

Mr. Megariotis was asked about the reference to the \$551 million contribution to the teachers' pension fund. He said that most of that amount had been the state's payments for health care benefits.

The items were combined, he said, because New Jersey's health plan for retired teachers lies within their pension fund. It is not clear whether New Jersey's practices satisfy I.R.S. rules on the commingling of such assets.

Mr. Beaver, the division's director since 2003, asked Mr. Megariotis why he had accounted for health care costs that way.

"Those are not my numbers," Mr. Megariotis, a certified public accountant, responded emphatically. He added that New Jersey would not do it again. Both officials said the numbers had been approved by outside counsel.

As for the \$56 million pension contribution listed in the audited financial statements, Mr. Beaver said he preferred the state's actuarial reports — the ones showing a contribution of zero.

Seizing on \$5.3 Billion

To explain the \$56 million, though, Mr. Beaver and Mr. Megariotis recounted a bit of history. In 2001, the Legislature voted to increase teachers' pensions by 9 percent, raising the plan's total cost by an estimated \$3.1 billion. Because New Jersey's Constitution forbids creating debts without creating a funding source, the

lawmakers needed to pay for it. They looked back to June 30, 1999, the height of the bull market.

Records showed that the pension investments were worth \$5.3 billion more on that day than the plan's actuary showed, because actuaries phase in gains and losses slowly to avoid sudden swings in market value. The lawmakers seized on this paper gain of \$5.3 billion, and voted to channel it as an actual windfall into a new reserve in the pension fund, to pay for the new benefits.

I.R.S. officials said that a company would not be permitted to do this with a pension fund.

By the time the Legislature did this in 2001, of course, the stock market had tumbled and much of the \$5.3 billion had melted away. That appeared not to have concerned the Legislature. An election was looming, and the teachers' union was complaining bitterly about past failures to put money into their pension fund.

John O. Bennett, the Republican who was co-president of the State Senate in 2001, said the DiFrancesco administration had pushed for the increase and said there would be money to cover it.

"Now history has shown that that hasn't been the case," said Mr. Bennett, who abstained from voting on the bill because it also increased the pensions of legislators.

Mr. Beaver, of the Treasury, said he thought the Legislature "went back and rewrote history" when it passed the 2001 bill.

This unusual arrangement did not last long. Two years later, the state needed to make a big contribution to the pension fund as those earlier market declines showed up in its overall value.

Lacking the resources, the state laid claim to the special reserve. The assets were recycled back into the main body of the pension fund — and labeled a state contribution. That was \$56 million in one year, Mr. Beaver said pointing to the state's audited financial report. The state did this three years in a row, until fiscal 2007, when the reserve was empty.

Independent experts said they could not understand how New Jersey could designate this a pension contribution. "It's a real misnomer," said Mr. Turner, the former S.E.C. official. "The reality is, there was no new money."

Because steps like these were taken over many years, it is difficult to judge the accumulated damage to the New Jersey system, experts said.

"It would be a really shocking picture, to show it all in one place, all the money that's been taken out of the retirement system at precisely the times when the benefits were increased," said [Douglas R. Forrester](#), who ran New Jersey's pension fund years ago, in the administration of [Thomas H. Kean](#). In 2005, Mr. Forrester,

[a Republican](#), ran for governor against Mr. Corzine.

The state has about \$31 billion of long-term debt outstanding, most of it in bonds. But Mr. Forrester said he thought that if all the unfunded debts of the state retirement system were correctly measured and added to that, “you’d get a number that’s about \$175 billion.”

“I don’t see how we’re going to get out of this,” he said.

David W. Chen and Jo Craven McGinty contributed reporting.

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April 5, 2007

Outside Audit Is Promised for New Jersey Pension Fund

By [RICHARD G. JONES](#)

TRENTON, April 4 — Gov. [Jon S. Corzine](#) said on Wednesday that he would ask independent auditors to examine state financial records to determine how severely the pension fund for state and local workers has been jeopardized by underfunding.

The governor's comments, which came during a news conference at the State House, were made in response to an article in The New York Times on Wednesday that described how [New Jersey](#) has diverted hundreds of millions of dollars that should have gone into the pension fund.

Mr. Corzine said the state government did not have auditors who were qualified to conduct a thorough examination of the fund, which, with reported assets of about \$79 billion, is the nation's ninth-largest public-sector pension fund.

"We do not have the expertise to do the actuarial assessment; we have to get an outside consultant," he said.

The analysis of state pension records by The Times showed that the state recognized the pension fund's investment gains immediately, but delayed the reporting of losses, used money earmarked for pensions for other purposes like giving aid to poor school districts, and routinely exaggerated how much money it had contributed to the fund.

In 2005, The Times found, the state reported in various accounts that it had contributed three different amounts into the state pension fund for teachers. The actual figure was one of those amounts: zero.

Mr. Corzine said on Wednesday that state officials had recently reviewed an audit that found the fund had a deficit of about \$25 billion. But some experts have estimated that the shortfall is much larger than that.

Whatever the figure is, the governor said, the shortfall must be closed.

"The fact is we have a huge hole," said Mr. Corzine, who has warned of problems with the pension system since taking office 15 months ago. "It has been created by a failure to deal with the issue, frankly, for the better part of a decade, and I consider it one of our greatest challenges."

Aside from the financial questions, Mr. Corzine acknowledged that the state was also reviewing the legal issues surrounding the diversion of money and the inaccurate reporting of contributions. Those practices could run afoul of pension management rules set forth by the [Internal Revenue Service](#) and the financial reporting rules of the Securities and Exchange Commission.

Federal power to regulate state pension management is limited, however. Donald J. Segal, chairman of the American Academy of Actuaries' pension practice council, said yesterday that the group had put state pension funding onto the agenda for its next meeting after reading that New Jersey had repeatedly failed to finance its pension plan as required by state statute.

Mr. Segal said that he did not think New Jersey was the only place where such things had happened, and that the council wanted to discuss what could be done, in the absence of federal pension rules. One possibility, he said, would be to change professional standards, so that actuaries working for governments would be required to speak out if a government was failing to make its required pension contributions. At the moment, governmental actuaries cannot do so without breaking confidentiality agreements or risking dismissal.

Officials with the state's Department of the Treasury have said that they have done nothing illegal.

Mr. Corzine said that regardless of what legal issues arise — or penalties the state might face — New Jersey must find new ways to fill the pension deficit.

“Whatever the outcome ultimately of someone reviewing this under federal I.R.S. regulations, we have a responsibility to close that gap,” he said. “We’re trying to take steps on that.”

The question of the solvency of state's pension fund is a result of years of questionable practices by Republican and Democratic legislators and former governors.

State Senator Leonard Lance, the Republican minority leader from Hunterdon County who is a longtime advocate of greater transparency in the government's financial dealings, called for “an immediate and public accounting.”

Mr. Lance called on the state treasurer, Bradley I. Abelow, and the head of the Division of Pensions and Benefits, Frederick J. Beaver, to appear before the Senate Budget and Appropriations Committee.

“I am deeply disturbed, but not surprised, by media reports that have revealed the scope of the present deficit and potential long-term insolvency of the state's pension fund,” Mr. Lance said.

The Senate president, Richard J. Codey, who was Mr. Corzine's predecessor as interim governor for 18 months, noted that the state contributed more to the fund in 2006 — about \$1.1 billion — than at any other

time in recent years. That amount still fell short, however, of the required contributions for that year, \$2.2 billion. Of that amount, \$1.6 billion was to have been contributed by the state and the rest by local governments.

Mr. Codey said he was confident that Mr. Corzine would begin to put the state's pension system back on track.

"We're no different than a whole host of states that are out there," said Mr. Codey, a Democrat from Essex County. "When I was governor we used to say a weekly novena that the stock market would go up" — and increase the fund's value — "but I don't think any retiree has to worry. We're nowhere near that point."

Mary Williams Walsh contributed reporting.

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